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Office of the Secretary of Transportation

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May 16, 2000

Vernon A. Williams, Secretary
Surface Transportation Board
Suite 700
1925 K Street, N.W.
Washington, D.C. 20423-0001

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Re: Major Rail Consolidation Procedures
<u>Ex Parte No. 582 (Sub-No. 1)</u>

Dear Secretary Williams:

Pursuant to the Decision served March 31, 2000, enclosed herewith are the original and twenty-five copies of the Initial Comments of the U.S. Department of Transportation in the above-referenced proceeding. This document is also contained on the enclosed computer diskette, formatted for WordPerfect 5.1.

Respectfully submitted,

Paul Samuel Smith

Paul Samuel Smith
Senior Trial Attorney

Enclosures

cc: All Parties of Record

ORIGINAL

Before the
Surface Transportation Board
Washington, D.C.

RECEIVED MAY 16 2000 MAIL MANAGEMENT STB

Major Rail Consolidation Procedures	)	Ex Parte No. 582 (Sub-No. 1)

Initial Comments of the
United States Department of Transportation

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I. INTRODUCTION

The United States Department of Transportation ("Department" or "DOT") welcomes the opportunity to participate in the reassessment of the criteria utilized by the Surface Transportation Board ("Board" or "STB") to consider major railroad mergers and consolidations. Ex Parte No. 582 (Sub-No. 1), Advance Notice of Proposed Rulemaking (served March 31, 2000) ("ANPRM"). As Secretary Slater stated at the Board's hearing in March, the railroad industry has undergone significant changes in the last twenty years; investment and productivity have increased, rates and costs have declined, and the Class I rail sector has become more and more concentrated. The prospect of even more consolidations in the next few years makes it imperative that the Board ensure that the standards by which it judges mergers will continue to protect and enhance the public interest. Given the vital national concern underlying this proceeding, we have undertaken a series of outreach meetings with railroads, shippers and other transportation-related groups. What we have learned from those meetings has shaped our views.

DOT shares the Board's concern with the implications of an "endgame" state of the railroad industry, which could lead to two major transcontinental carriers. We cannot predict whether such an industry structure is *per se* good or bad for the transportation system and the country. Much depends on the circumstances of future individual transactions. However, as we stated in our prior written comments, and as Secretary Slater emphasized in March, we believe that the potential risks and uncertainties of this structure mandate that any merger from now on must undergo much more intensive scrutiny. A two-carrier system inherently brings with it a heightened risk of failure, and the potential for less than vigorous competition in all markets. The severe implementation problems of recent major transactions indicate that the consolidation of major systems can raise significant and unanticipated integration problems in the short run. Larger and larger railroads may also pose ongoing management challenges that could stymie the introduction of operating efficiencies. These risks may not be outweighed by public gains. While the potential for productivity improvements from parallel consolidations has long been recognized, most studies indicate few public benefits from end-to-end mergers such as those we would likely expect in the future.

We in no way recommend that future mergers be rejected out of hand. Nevertheless, given the present condition of the industry, applicants should face much greater hurdles than those in past merger proceedings to minimize these risks. As we discuss more fully below, they must be required to present strong evidence of the steps they would take to minimize risk and provide public benefits. If approved, mergers should be subject to more extensive oversight and heightened conditions, to guard against service problems, and to protect competition. A healthy, competitive railroad industry is vital to our national transportation system and to our economy as a whole. The Board must work actively to help achieve and maintain that goal, approving mergers that would foster that result and rejecting those that would not.

While focusing on the future state of the industry, the Board cannot ignore the need of today's railroads to respond to a constantly changing market. The market will not stand still, and neither can the railroad industry. We therefore urge the Board to act expeditiously in this rulemaking and to conclude the process rapidly, even before its self-imposed deadline of 15 months. Moreover, as Secretary Slater indicated in March, rulemakings are not the only procedure by which the merger standards can be revised. The Board always has the authority to refine its criteria in the context of each case, and has used this authority many times in the past when the public interest dictated the need for a change. The STB can use this rulemaking to outline the major changes in merger review policy, and improve the policy as necessary in defining the scope of particular proceedings.

II. SUMMARY

The Department's initial comments in this proceeding focus on steps the STB can take to prevent or mitigate problems directly related to future consolidations of major rail carriers. We address the topics and proposals put forth in the ANPRM, and also recommend potential actions in areas not mentioned by the Board. Our proposals are designed to raise the evidentiary threshold for future mergers in an industry that is already highly concentrated, where transactions are likely to pose significant risks and offer relatively few public benefits. DOT also offers recommendations designed to help ensure a smooth implementation of mergers that are approved. Finally, our comments also urge the Board to reject options covering issues that would address wider, non-merger related matters.

Specifically, the Department believes the Board must require more extensive quantification of the public benefits of major rail combinations, and a more detailed accounting of the investment and operational steps the applicants will take to ensure that the benefits are realized and the risks avoided. Only by significantly more rigorous analysis will the Board be able to weigh the potential public benefits of a merger against any risks it might pose.

For any merger that is approved, we agree with the Board's proposal to maintain the existing process for the Safety Implementation Plans. This flexible, transaction-specific approach has worked well to prevent merger-related safety problems. To ease the transition to a merged system, the Board should require staged implementation, detailed contingency plans, benchmark data and other steps. It should also encourage indemnification of shippers, short line railroads, Amtrak, and commuter railroads against significant implementation-related service problems. A more rigorous assessment of the potential financial situation of the carrier post-merger, to determine the extent of a traffic and/or revenue downturn it could sustain, should be routine. Additionally, more intensive scrutiny of new consolidations should be required where one or more of the merger partners' past transactions have led to implementation problems, particularly if they are still unresolved.

To protect the rights of employees affected by a consolidation, and reduce the impact of the transaction, the Board should administratively restrict the use of its cram down authority to override collective bargaining agreements, enhancing relocation options and requiring pre-merger completion of implementing agreements.

Additional protections for shippers should also be considered if the rail industry becomes more and more concentrated. Major gateways should be maintained, to provide shippers with leverage. Competitive options should be expanded by requiring reciprocal switching at terminals, at rates that both encourage competition and protect the serving carrier's incentive to invest. Procedural hurdles for implementing relief under the "bottleneck" decision should also be removed for eligible shippers on lines included in the merger.

The experiences of the Union Pacific/Southern Pacific merger and the breakup of Conrail indicate that many of the adverse community and environmental impacts of a consolidation are not addressed by the Board's current procedures. We propose that the Board expand the universe of communities eligible for environmental mitigation, and require more careful planning and investment to avoid congestion problems at urban crossings.

Combinations that involve railroads of different countries potentially raise issues that are qualitatively different than those presented in mergers of U.S. carriers. The Board should explore these issues in each case; the record thereby created will provide a basis to address any problems encountered.

DOT believes that the Board is correct in its decision to move from a case-by-case approach to one that attempts in each merger to focus on the "downstream" effects that consolidation would have, however illusive, on an already concentrated industry.

III. MERGER-RELATED SAFETY ISSUES

In recent major rail mergers the Surface Transportation Board has required applicants to work with the Federal Railroad Administration ("FRA") to formulate Safety Integration Plans ("SIPs") to ensure that safe operations will be maintained throughout the entire period of implementation. The SIP process is an example of how the Board and FRA have modified their analytical approach to merger approval to accommodate safety issues that have arisen as the industry becomes more concentrated. The *SIP Guidelines*, promulgated by FRA in November 1997, require merger applicants to describe in detail how the railroad will operate safely once the acquisition is complete, how elements of the acquired/merged properties will be integrated, efforts made to comply with applicable regulations, proposed allocation of resources (capital, facilities, technology and personnel) and the schedule for implementing plans. [1] There are currently thirteen different items required to be addressed in each applicant's plan, ranging from track and structures to dispatching operations to information systems compatibility.

The SIP requirement in each case has been implemented through a Memorandum of Understanding ("MOU") between the STB and FRA, although a joint rulemaking to formalize the process is under development. 63 Fed. Reg. 72225 (December 31, 1998). The two agencies, working in conjunction, have proposed regulations designed to ensure adequate and coordinated consideration of safety integration issues in railroad merger cases. The STB has already solicited and received comments in that proceeding, and a joint hearing was held by the two agencies.

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[1] *Safety Integration Plan Guidelines*; Federal Railroad Administration; Rev. 3 of 11/24/97.

SIPs are being used very effectively in the safety-related oversight of two recent mergers, the 1998 acquisition of Conrail by the Norfolk Southern railroad ("NS") and CSX Transportation ("CSX") and the 1999 merger of Canadian National ("CN") and Illinois Central ("IC"). Respectively, Finance Docket No. 33388, Decision No. 89 (served July 23, 1998)(slip opinion) and Finance Docket No. 33556, Decision No. 37 (served May 25, 1999)(slip opinion). To date, no major safety problems have emerged with the CN/IC merger. However, the rollout of information technology ("IT") systems that will fully integrate IC into CN is not scheduled to commence until mid-summer 2000. FRA's MOU with STB in that case, executed in September 1998, provides for up to 5 years of oversight by FRA on merger safety matters, or until FRA affirms to the Board that the integration has been completed satisfactorily.[2]

Despite the service problems experienced, the overall safety of CSX and NS (within their own systems and in the "shared asset" areas) has improved compared to the same pre-merger period of a year ago. However, continuing IT problems at all three companies have led to missing and/or inaccurate billing and train consist information that could lead to safety problems, particularly for hazardous materials shipments. Other safety concerns have included runaway trains on mountain grades, an inordinate number of highway-rail grade crossings blocked for extended periods of time by NS and CSX, particularly in Ohio, and numerous complaints regarding "train horn noise" at crossings.

The flexibility of the SIP process allows the procedures devised by rail applicants and the FRA to be refined based on experience, and this process will continue in any new wave of major rail mergers. FRA is considering expanding the *SIP Guidelines* to cover the new issues that have emerged in the Conrail acquisition, and would expect to tailor individual SIP's to meet the specifics of any merger under evaluation.

IV. MERGER-RELATED SERVICE STANDARDS

The railroad industry is a service industry, and the quality of that service both determines the health and future of the industry and directly affects the health and future of shippers throughout our nation. As the Board pointed out in its decision initiating this proceeding, the current railroad merger regulations were adopted nearly two decades ago in an environment of "deteriorating

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[2] *Memorandum of Understanding Between the Surface Transportation Board and the Federal Railroad Administration/ CN and IC Merger*, Finance Docket No. 33556, Implementation of Safety Integration Plan, September 28, 1998.

service levels." ANPRM at 2. Those merger regulations guided merger applicants and the Board in streamlining a balkanized industry structure, eliminating excess capacity and generally rationalizing the rail network. As a result, rail freight service has improved, and shippers and the public have benefited from the railroads' resurgence.

However, those same merger regulations have too often failed to protect the public from significant service disruptions in the wake of major railroad mergers. In the last five years as the pace of consolidation in the industry has accelerated, public and shipper confidence in rail service has been damaged by mergers that not only failed to deliver the service improvements promised, but, in fact, resulted in worse service during the post-merger transition period.

The service problems associated with recent major railroad consolidations have made it clear that the old merger rules are not adequate to protect the public interest. In addition, the prospect of ever-larger consolidations underscores the need to modify the Board's criteria. Updated merger rules are needed to address service standards during the critical post-merger transition period. Listed below are a set of recommendations that the Department believes will provide the Board with tools to monitor post-merger service, provide shippers reasonable safeguards against harm from major service failures during the transition period, encourage sound planning, and hold applicants responsible for any service-related promises they voluntarily make – without inhibiting the innovation needed to move the rail industry into the Twenty-First century.

A. Service and Performance Statistics

A prerequisite to any regulatory strategy for addressing post-merger service disruptions is a base case set of service and performance measures. The Board has gained recent experience in evaluating which specific measures are best suited for its oversight responsibilities. *See* Finance Docket No. 32760 (Sub-No. 26). In addition, shippers have a somewhat different set of measures that they believe are critical to monitoring railroad service levels. Both the Board's and the shippers' points of view are legitimate, and DOT submits that applicants should be required to provide base line data for at least the twelve-month period before the filing of a merger application.

The reporting requirements that were imposed on the Union Pacific ("UP") following the Houston service meltdown, and on CSX and NS following the Conrail acquisition, would form the starting point for developing the types of base period statistics that should be required. The Department also recommends that the Board seek guidance from shippers on the type of base line data the shippers would find most useful. We have heard from various shippers that statistics that are developed by railroads, such as dwell time in terminals and average velocity, are not particularly useful to shippers. Therefore, the required metrics should quantify operational performance as well as capture meaningful service measures, which may include cycle times, origin-destination transit times, or percentage of on-time shipments.

B. Post-Merger Service Councils

The Conrail Transaction Council that grew out of a pre-merger agreement between the applicants and the National Industrial Traffic League should also provide a model for the future. Finance Docket No. 33388, Decision No. 89 (served July 23, 1998)(slip opinion) at 54. This Council serves as a forum for timely and efficient communication of information concerning the merger implementation process, where shippers may suggest mechanisms to address any perceived obstacles to the effective implementation of the transaction. The Department believes that the concept is sound and should be made a standard part of all future mergers.

The service council should not be a substitute for Board oversight, but we believe it is helpful to have a working group of interested private parties and government agencies to meet regularly with the merged carrier for frank and open problem identification and for the development of mutually agreeable steps to resolve service or other problems that might arise.

C. Transitional Service Plans

DOT also believes that a transitional service plan ("TSP") would be a beneficial planning tool to ensure completeness and logical sequencing in the steps necessary to coordinate the post-merger delivery of rail transportation service over the consolidated network. The TSPs should address how the applicants intend to merge their respective operations in light of the litany of past service problems that have followed recent mergers (including congestion, poor car tracing, and irregular service), as well as their probable causes (such as understaffing, IT deficiencies, bottlenecks, and equipment shortages).

We believe that transitional service plans could have some of the same characteristics as safety integration plans. For example, they would address the allocation of resources necessary to maintain and improve upon pre-merger service levels. However, we recognize that unlike a safety implementation plan, government agencies do not routinely possess the expertise to judge the inherently commercial aspects of a transitional service plan. As a result, the presumption should be that the applicants have the appropriate expertise to develop the plan, and interested parties should review the service plan in much the same way that they now review the applicants' operating plan or competitive analysis. The main difference from the standard operating plans should be that the focus of the TSP would be on allocating resources and having logical processes in place to maintain service during the transition period following the consolidation.

As with any plan, the utility of the transitional service plan will be a function of the effort that goes into its development, constructive suggestions from commentators, the follow-through or execution of the plan, and a feedback mechanism to monitor whether the plan is on course and meeting intermediate targets. The base line statistics and the service council recommended above are examples of the measurement and feedback components that would enhance the utility of the transitional service plan.

The Board should use its discretion regarding the level of planning detail appropriate for the TSP in the context of each merger. The Board would not necessarily pass judgment on the plan *per se*. However, such a plan would provide useful information to shippers, who would have a better idea what to expect immediately after the merger. In addition, public airing of a transitional service plan may uncover nuances that are more apparent to shippers than to the railroads themselves and provide an opportunity for adjustment.

D. Contingency Plans for Service Breakdowns

In the past, merger applicants have professed that they have learned from previous merger-related service failures, and that the lessons learned will ensure that the same missteps will not be repeated. The record of at least some mergers, however, demonstrates that the scope and complexity of contemporary railroad operations have raised the probability that unanticipated service implementation problems potentially may arise even with extensive planning and review. Thus it is that even a detailed transition service plan may prove insufficient to avoid extensive post-merger difficulties.

Therefore, the Department also recommends that the Board revise its rules to require carriers to submit contingency plans for service breakdowns as part of the merger application process. Under this recommendation the applicants would propose target measures for post-merger service. In addition, they would submit contingency plans for key corridors and yards where there was to be a significant change in operations or a significant change in traffic volume as a result of the merger. If the service measures indicated declining service levels, the contingency plans would be activated. The plans could cover staffing, equipment, access to other railroads, or granting another carrier trackage rights to maintain service levels.

The Department recognizes that not every contingency can be planned for and that there are substantial practical problems with guaranteeing that additional resources such as railroad equipment or qualified staff will be available on short notice to maintain certain levels of service. On the other hand, what is at issue is meeting projected service levels that the railroads have formulated themselves. Moreover, railroads historically do cooperate in the face of natural disasters to share facilities to maintain service, and a certain amount of contingency planning occurs now that has resulted in operating crews from one railroad working temporarily to assist a carrier with a post-merger service problem. The Department believes that, within limits, and in concert with other service performance safeguards, contingency plans would help minimize post-merger service disruptions.

E. Service Guarantees

The Department also recommends that applicants and shippers or shipper groups should be strongly encouraged to enter into contractual agreements that guarantee minimum levels of service during the post-merger transition period. We believe that service guarantees provide a check against over-confidence or over-exuberance on the applicants in promising service improvements. If the applicants fail to provide the service guaranteed, then the shipper would be entitled to compensation, which could be in the form of access to alternative transportation service, rate discounts, or recovery of losses. The details of the service guarantee could be worked out between the applicants and the individual shippers and shipper groups, and should be tailored to fit specific merger cases.

The intent of this approach is primarily to protect shippers from service deterioration. That is, the applicants would be expected to offer guarantees to shippers that transit times and reliability would not be degraded as a result of the consolidation during a transitional period. A secondary objective would be to encourage applicants to provide assurances that promised public benefits in the form of improved service would be guaranteed to shippers. If the service guarantees were not met, then the applicants would be legally obligated to pay agreed-upon damages or provide for agreed-upon access to alternative transportation, or whatever was spelled out in the service guarantee.

Minimum service guarantees would restrain overly optimistic service projections by the applicants, and also penalize the applicants -- and not the shippers -- if the promised service levels are not met.

The Board has a mechanism available that could fit well into administering transitional service guarantees. The Railroad-Shipper Transportation Advisory Council (established by the ICC Termination Act) recommended, and the Board adopted, rules for the binding, voluntary arbitration of certain disputes subject to the jurisdiction of the Board.[3] In its rules for the informal dispute resolution procedure, the Board stated that this arbitration mechanism would be appropriate for the resolution of post-merger disputes.[4] This arbitration procedure was intended primarily for small entities, and the Board would need to revisit the rules in light of this proceeding to adapt the arbitration mechanism to transitional service guarantees. However, the mechanism is available, and the Department believes it could be relatively easily tailored to address the resolution of service guarantee disputes.

F. Staged Implementation

In general, service issues were not a major concern in railroad consolidations until the mid-1990's. However, since the merger of the UP and Chicago & North Western railroads in 1995, post-merger service problems have been an increasing concern for shippers, railroads and government agencies. Despite assurances of lessons learned from merger applicants, the service problems continue. The root causes of post-merger service failures remain largely an enigma. Each time there has been a service breakdown following a rail consolidation, the circumstances of the service disruption have appeared to be unique. The STB in its summary of the testimony received in Ex Parte No. 582 states: "Railroad chief executive officers (CEOs) involved in the last round of mergers testified how difficult merger implementation can be, even with the best planning and with the experiences of prior mergers to guide them." Decision served March 17, 2000, at 3.

Prior to this time, merging carriers often (but not always) maintained separate operations (and identities) for extended periods of time. Although the pace of the economy has accelerated dramatically and there is arguably greater pressure for quick results, the time-proven method of a consolidation implemented in steps may avoid or minimize the service failures that have resulted in losses for both carriers and their customers. In addition, a staged implementation may be the most effective mechanism available to regulators to regain control of a problem that to date has eluded resolution through alternative

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[3]Ex Parte No. 560, Decision served September 2, 1997.

[4]Id., at 3.

means.[5]

Under a staged implementation, applicants would have to demonstrate to the Board that they have successfully integrated administrative and support functions such as information technology systems, billing, customer service, and crew calling before they would be permitted to integrate dispatching, power distribution, or operations. A staged implementation would have more the character of an assimilation than a takeover. A staged implementation would also provide an answer to the problem that occurs when merger integration teams are handicapped during the regulatory review process, because they do not have access to certain types of competitive information, including shipper contracts.

Although it would be impossible to design a staged implementation plan that would fit all consolidation cases, the Board could put the burden on the applicants to develop a sequential implementation plan with target dates for review by the Board before the next stage in the integration occurs. If the target was not met, then the operational integration of the carriers would be delayed.

Staged implementation under the Board's oversight would not, in our view, be necessary in all mergers. Railroads that did not intend to integrate operations within the first three years following approval, for example, should not be required to submit a plan for a staged implementation. The requirement for staged implementation should be designed for a case where the applicants intend to move rapidly to full integration, and the size and complexity of the merger inherently carry the risk of transitional service-related problems. DOT believes the Board should have this type of option available when faced with large, complex merger applications and a tight schedule for full integration of the properties. In those cases, if the supporting functions such as information systems, accounting, and crew management are not successfully integrated, then service levels cannot be maintained and customers will bear the consequences.

The Department recognizes that the planning and execution of a merger is a management responsibility. Too much oversight of basic management responsibilities is not the role of government and, in any event, has its own set of costs. However, given the critical importance of each of the major railroads to the national transportation system and the economy, there is a strong case for having effective checks in place to protect the public interest, particularly during the finite period when successful integration must occur.

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[5]Despite the fact that the Board imposed several conditions in the Conrail transaction to prevent post-merger service problems and the repeated delays in the control date, both NS and CSX have experienced significant service problems.

G. Review of Prior Merger Service Records

As part of the merger review, the STB should also examine in depth the merger experience of applicants with regard to prior service issues, and whether there is any indication that merger-related service problems continue to be a problem or are likely to recur. The burden should be on the applicants to demonstrate that safety and service measures are stable and at least equal to, if not better than, pre-merger levels before they could move forward into another consolidation.

The Department believes that a carrier's past record of post-merger service performance is a relevant indicator of future performance. In addition, the public is entitled to a thorough explanation from any carrier that failed to maintain pre-merger service levels in the past of specific actions taken and procedures instituted to prevent a repeat of past substandard performance. This should be required before regulatory approval is granted to expand operations and market share through another acquisition.

V. MERGER-RELATED COMPETITION ISSUES

Addressing the post-transition downstream and crossover effects of a new round of consolidations that could lead to a national or international rail duopoly requires an expansive view of the risks and probable benefits and drawbacks of such mergers, not just in terms of the traditional impacts on shippers, but with respect to broader societal effects in the long run.

Economists focus on productive and allocative efficiency, where productive efficiency is measured by the resource costs imposed on society for producing the product or service, and allocative efficiency is measured by the prices charged society for the product or service. The Interstate Commerce Commission and the STB have long regulated prices (rates) to protect shippers and the public from monopoly pricing, and rate regulation will likely continue to be necessary in the long run to protect society.[6] However, the Board's request for

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[6] Pricing at marginal cost is the theoretical optimum for allocative efficiency. However, because the railroad industry continues to be characterized by decreasing cost, where marginal cost is less than average cost, marginal cost pricing fails to recover full costs. Therefore, as the Board has long recognized, railroads need to use second best, Ramsey-like, differential pricing to recover full

comment on six initiatives to enhance competition not only raises pricing issues, but extends to probable effects on resource costs imposed on society.

DOT has examined the Board's suggested competition enhancements in the above context of productive and allocative efficiency, focusing primarily on the probable joining of the major Eastern and Western railroads in end-to-end mergers spanning the Midwest gateways.

A. Maintaining Open Gateways

The major benefits to society from rail mergers stem from the opportunity for the merging carriers to realize economies of scale, density, and scope, all of which can reduce the resource costs to society of providing rail service. A recently completed research study commissioned by FRA confirms the results of earlier studies: it finds that there are few or no such scale economies that can be realized from end-to-end mergers.[7] It is clear, therefore, that maintaining or enhancing the existing joint-line alternatives for movements bridging the Midwest gateways would not cause important savings in resource costs to be forgone.

Consequently, the Department supports the proposal to maintain open gateways for joint-line movements to preserve competition threatened by merger — with some reservations. Preserving joint-line routing options does provide the shipper valuable leverage in negotiating rates and service with both the merged carriers and the carriers party to a joint-line movement. However, there are other issues that need to be resolved.

Conditioning a merger to require open gateways may unduly penalize the merging carriers if other, competing carriers serving the gateway are not required to meet the same standard. The merged carrier would be subject to joint-line competition from the non-included carriers but could be prevented from competing for joint-line movements that are originated/terminated by

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costs, with regulation capping prices at Stand Alone Cost ("SAC") to prevent railroads from collecting monopoly rents.

[7] Bitzan, John D., *Railroad Cost Considerations—Implications for Policy* (Study Commissioned by the Federal Railroad Administration), Upper Great Plains Transportation Institute, North Dakota State University, May 10, 2000. The study is available to all interested parties on the FRA web site, the URL for which is: www.dot.gov). A copy of this study is included herewith on computer diskette for the STB's convenience.

those competing carriers. DOT suggests the Board consider a merger condition requiring that all carriers serving the gateway be required to maintain open gateways.

Finally, this prescription brings with it an issue concerning rates. The railroads joining in end-to-end mergers have an incentive to price a movement to or from a gateway (if one is offered at all) that makes a joint-line option economically unattractive relative to the rate for through movement offered by the merged railroad. In a sense, shippers faced with this situation may be somewhat in the situation of captive shippers. If open gateways are to be maintained, as proposed, the Board must grapple with this issue, and in so doing must assure that the rate to/from the gateway is set to maintain or enhance productive efficiency. The present arrangements for rate/revenue divisions for joint-line movements over the gateways could be considered as a benchmark for setting such rates.

C. Open Switching to Exclusively-Served Shippers in Terminal Areas

The Board has asked whether it should require merger applicants to provide switching, at an agreed-upon fee, to all exclusively served shippers located within or adjacent to terminal areas. ANPRM at 8. Currently, depending on the particular competitive situation in a terminal area, some or all shippers may be exclusively served by a carrier, and denied access to a competing carrier through terminal switching. Even where switching is officially "open," the level of switching fees can be set to make switching to a competitor prohibitive. Further, as a consequence of mergers, new competitive conditions are often created that can lead to closing of switching previously open.

Shippers have charged that mergers and route restructurings over the years have limited competitive alternatives, with one consequence being the elimination of geographic competition as a realistic force in maintaining market discipline. The Department believes that opening switching at terminal areas would help to restore this type of competition, and has included a provision to mandate reciprocal switching at all terminal areas in its legislative proposal for STB reauthorization.[8] While the application of this condition in a merger will

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[8] H.R. 3136. At DOT outreach meetings with various groups, there were claims that prior to announcing mergers, carriers cancelled switching in terminal areas without notifying affected shippers. As a consequence, shippers who previously had multiple carrier options may be find that they are captive to one carrier. Allowing open switching in terminal areas removes the need for the

only help those shippers served by the merger applicants, it is a useful approach to mitigating any potential loss of product or geographic competition. To be effective, however, switching fees must be set (either through negotiation or, failing that, STB direction) at levels that will encourage competition, but maintain efficient routings and adequately reimburse the carrier physically performing the switching service (including sustaining the incentive to continue investment in infrastructure).

D. Expanding Competitive Options by Amending the Procedures for Bottleneck Relief

In its "Bottleneck Decision," the Surface Transportation Board has provided guidelines for shipper relief. Central Power & Light Co. v. Southern Pacific Transportation Co., Nos. 41242 et al. (served December 31, 1996), *clarified* (April 30, 1997). Those shippers with a contract from a carrier over the competitive segment of a bottleneck move are in a position to challenge the rate on the bottleneck segment. However, for those shippers seeking a separate through route and point of interchange from the one offered by the bottleneck carrier, the Board determined that a shippers with a contract over the competitive segment must first pass the "competitive access" rules before it can challenge the rate. Id.

As possible avenues by which to expand competitive options for shippers, the Board has proposed two changes in the procedures that it uses to provide bottleneck relief. ANPRM at 8. The Board's two proposals for relief address the two parts of a bottleneck route. The first would require the merger applicant to offer contracts to shippers over the competitive portion of the route when a railroad not party to the merger is the bottleneck carrier. The second would require the applicants to offer rates over the bottleneck portion to reasonable interchange points when one of them is the bottleneck carrier. Id.

Requiring the applicants to offer contracts over the competitive portion of a route would allow the shipper to demand a rate over the bottleneck segment. The rate for the bottleneck segment could then be challenged under the standard rate reasonableness tests. Requiring the applicants to offer rates to competitive interchange points over the bottleneck segment when the shipper has a contract would permit shippers that have entered into contracts to immediately seek rate relief, rather than first requiring them to file an access complaint for a new route.

Board to investigate this issue or for the Board to order merging carriers to identify all terminal areas where switching was cancelled prior to the merger.

Both proposals are attempts by the Board to provide greater relief under its Bottleneck Decision than has been the case to date. Carriers upstream or downstream of a bottleneck connection have evidently been reluctant to enter into contracts, thus preventing shippers served by a bottleneck carrier from applying for a route to an interchange. Imposition of the contract requirement on merger applicants would enhance competition by increasing rate and route options. Imposition of the "rate to the interchange" requirement would allow shippers procedural relief, if they already had a contract from the bottleneck onward.

DOT believes that the first option, requiring applicants to offer contracts over the competitive segment of the proposed route, is not within the Board's present legal authority. Federal law allows railroads to offer contracts, but does not compel them to do so. 49 U.S.C. § 10709. Even in the case of grain, where special provisions are made to protect shippers against discrimination, carriers are only required to provide non-contract shippers with tariff rates and services that mirror the contractual rates and services of similarly-situated contract shippers. 49 C.F.R. § 1313.9(3)(i). Moreover, requiring a contract in a bottleneck situation is no guarantee that the contract will be acceptable, either in terms of rates or service, to the shipper.

DOT believes that the Board's second proposal, requiring the applicants to offer rates to an interchange where the shipper already has a contract with the competitive route carrier, should be pursued. For a shipper that has secured a contract, the proposal would simply expedite or streamline the current two-step process: first, a proceeding to establish access, followed by a possible second proceeding to challenge the rate. The Board's proposal would eliminate the first step for shippers served by merger applicants.

Bottleneck access is a broad industry issue that ideally should be resolved in a rulemaking or by statute, after full debate about the implications for rail costs, rates and service. Although recent research establishes that railroading is still a decreasing cost industry, and thus requires differential pricing to recover full costs, differential pricing can be compatible with an efficient access price for the bottleneck, namely, a price that could permit a more efficient carrier than the incumbent to capture the business. However, imposition of an inappropriate price for bottleneck access could penalize a more efficient bottleneck carrier and increase costs to society by shifting traffic to the less efficient carrier.

E. <u>"Three-to-Two" Issues</u>

The Board has sought comment on how "three-to-two" effects should be reflected in its new merger rules. ANPRM at 9. Specifically, the Board questions if it should give greater weight to arguments of competitive harm in corridors where the number of serving carriers are reduced from three-to-two or whether this issue should be examined on a case-by-case basis as it has in the past.

The question of whether three carriers provide measurably greater competition than two carriers was the major competitive issue addressed in the merger of the UP and the Southern Pacific railroad. At that time, the Department maintained that economic theory held that the competitive outcome of duopoly was indeterminate; it could result in intense rivalry or comfortable accommodation, depending on the specifics of the situation. The Board decided that two carriers were generally sufficient to maintain competition. Finance Docket No. 32760, Decision No. 44 (served August 12, 1996)(slip opinion) at 107-108 and 119-121.

The Department believes that the three-to-two issue is essentially moot at this point, since there are few or no major routes today served by three railroads. Furthermore, the most likely prospective mergers are end-to-end. However, there may a number of <u>points</u> that continue to be served by three carriers. The current policy where the Board addresses the specifics of each situation on a case-by-case basis to determine if there would be competitive harm if the number of serving carriers is reduced from three-to-two should be sufficient.

VI. MERGER-RELATED FINANCIAL ISSUES

A number of parties throughout the four days of hearings in this proceeding raised the issue of the financial viability of merged systems. In particular, parties addressed problems with merger integration and how those problems affected carrier revenue. Many feared that integration problems further affected a carrier's ability to maintain cash flow and continued investment while undertaking to service and pay down debt incurred from the transaction. Additional concerns were raised about a carrier's financial health following the consolidation if projected traffic volumes did not materialize.

The Department shares these concerns. As Secretary Slater stated during his testimony before the Board, it is important to maintain "a rail system that is safe, competitive, and profitably able to meet the needs of consumers and communities." Although the ANPRM does not specifically request comments on financial issues, the Department would nonetheless urge the Board erect safeguards to ensure the accuracy of the pro forma data filed, and to develop and apply rigorous analytical methodologies that will assess the financial condition of the new entity if traffic and revenues fail to meet projections. This should include, at a minimum, a sensitivity analysis to give the parties a better understanding of the various possible financial outcomes and the probabilities associated with those outcomes. The analysis should cover the transition period, considering possible traffic losses and concomitant financial penalties for poor service.

It is also imperative that the analysis consider the impact on rates to shippers, as well as the merged carrier's ability to make the capital investment required to ensure service improvements. The outcome of the analysis should indicate the effect on fixed charge coverage and other financial benchmarks in order to understand the financial "safety" margin (the carrier's ability to meet its financial obligations) that would enable the carrier to remain viable through difficult economic times. Ideally, a cash flow analysis could be conducted to determine the degree of shortfall from projections that could be sustained and still provide sufficient "contribution" for the merged carrier to cover debt service requirements and fund needed capital investments.

Additionally, DOT would like to raise another finance-related issue. Several of the parties with whom the Department met over the past weeks raised the issue of "overpayment" in relation to a merger, arguing that any excessive costs of an acquisition should not be passed through to shippers. We are not yet convinced that this is a significant problem – or, if it is, one to which there is a workable solution – but we are reserving judgment until we see other submissions presented in this proceeding.

VII. MERGER-RELATED PASSENGER RAIL ISSUES

Except in the Northeast Corridor, Amtrak operates over the tracks of the Class I freight carriers. Despite statutory provisions directing freight railroads to give Amtrak's trains priority, Amtrak has suffered significantly from the service disruptions and congestion-related delays that have plagued implementation of recent mergers. While freight delays of hours are not significant in many cases, delays measured in hours (or worse) are not acceptable to passengers who have other options. These delays present serious Amtrak concerns in the long term, and very serious concerns in the immediate term. To help meet its Congressionally-mandated goal of financial self sufficiency by 2003, Amtrak has embarked on an aggressive plan to increase its passenger service and expand its express freight service. In order to implement this plan, it is essential that Amtrak be able to offer reliable service; consequently, the issue of possible delays due to merger transition problems is a particularly important one for passenger rail service.

Commuter rail operators share Amtrak's concern with delays. They also have rail capacity issues. A rail merger may lead to increases in freight traffic in certain corridors, which may interfere with either existing or proposed commuter rail operations, since such operations generally require the operation of numerous trains over a line segment during specific hours, every day, rather than one or two trains as might be the case with an expansion of Amtrak service. Service reliability is critical to building successful commuter operations, since regular customers quickly become disenchanted with unreliable service and will turn to other alternatives.

In order to address these concerns, the Department believes the STB should require merger applicants to include in their transition service plans the specific steps they will take in order to avoid disruption of passenger rail operations. This could possibly address capacity on certain corridors and contingency plans to ensure smooth passenger operations during transition. The passenger portion of the TSP would, like the freight portion, address current service levels, noting those where current performance is inadequate, and consider appropriate penalties for disruptions. The penalties should be at a level to provide an incentive for the merging railroads to solve the problem, although the Board should consider the possible impact of such penalties on the future willingness of freight railroads to allow additional passenger services on their lines.

Safe, efficient passenger rail service is critical to addressing congestion and pollution problems in many parts of the country. The STB should carefully consider these and other suggestions to address the problem of delays to passenger service caused by mergers.

VIII. MERGER-RELATED SHORT LINE AND REGIONAL RAILROAD ISSUES

The American Short Line and Regional Railroad Association ("ASLRRA"), on behalf of the short line industry, has raised a series of issues in this proceeding that it asks the STB to consider when reviewing future Class I mergers. Statement of Frank K. Turner, President, ASLRRA, filed March 8, 2000. These issues focus on Class I service, interchange and routing, pricing, and car supply to Class II and Class III railroads. In addition, in its comments in Ex Parte No. 582 the ASLRRA briefly discussed Class I merger integration planning and coordination between major applicants and their small carrier partners. Id. The Department believes that this is an important issue that should be addressed in this proceeding.

A. Service

The ASLRRA states that merger implementation and associated transition time in recent mergers have resulted in severe Class I service disruptions which, in turn, cause railroad service disruptions for Class II and III railroads that depend on connections to the merging carriers. As a consequence, small carriers have been unable to provide service to shippers along their lines. DOT understands that when possible, these shippers shift to alternative transportation. Small carriers report that in some cases these shippers never return once rail service improves. Furthermore, the ASLRRA claims that service disruptions resulting from mergers are often compounded by inadequate personnel on the Class I system. Small carriers are unwitting victims of these disruptions, and face revenue losses as traffic erodes, creating a situation where they can no longer make adequate investments to maintain the rail plant. To the extent that their shippers cannot secure other services, they, of course, share in these losses.

The ASLRRA requests that the STB approve no merger without "iron-clad guarantees" and assurances that the Class I carriers will promptly compensate the short line and regional railroads for revenue losses resulting from operating inefficiencies caused by the merger.

In its previous filing in Ex Parte No. 582, the Department addressed as a serious concern losses in traffic and revenue that small carriers experience when service problems mount during the operations integration phase of merging Class I systems. Because many of the small carriers and/or their customers may be financially frail, revenues losses, even in the short run, could result in the failure of these carriers and a loss to the community and the region of a critically important component of the rail infrastructure. Even if a small carrier does not fail, it might be placed in such a weakened financial state that it begins the cycle of deferring maintenance and deteriorating service, again causing economic injury not only to itself but to its shippers and their communities. Thus an unintended consequence of a Class I carrier's failure to implement and integrate its merger successfully has wide potential effect.

The Department recommends that the STB consider requiring Class I railroads, as part of any merger application, to establish and provide service benchmarks and negotiated service guarantees for Class II and Class III railroads with which they connect. These service guarantees could include compensation for small carriers if the merging carriers fail to meet agreed upon service levels and could also include provisions for access to other connecting railroads (the temporary removal of the so-called "paper barriers" in circumstances where service disruptions occur). Even though these small carriers are railroad customers, they are also railroads responsible for operating and maintaining portions of the rail network to provide service to their customers.

B. Interchange and Routing

The ASLRRA also states that small carriers have become captive to Class I railroads because of mergers. It claims that the line sales agreements restricting interchange, combined with the cumulative impact of consolidations that have eliminated routings and closed gateways, have created inefficiencies in the rail network. Statement of Frank Turner at 6. The ASLRRA requests that the STB change its merger rules and only approve Class I mergers if contractual barriers prohibiting interchange rights are removed and also give small railroads the right to interchange freely at gateways and in terminal areas without pricing or operational disadvantage.

As noted in the prior section on competitive issues, the Department agrees that gateways should remain open in order to preserve continued Class I options at these locations for shippers and small carriers. However, the Department is concerned about the permanent removal of "paper barriers" as a condition of a Class I consolidation, unless removal is required to resolve a competitive problem resulting from a merger or as a remedy for service-related issues. "Papers barriers" are contracts that the buyer of a small carrier entered into with the selling Class I carrier for favorable terms at the time of purchase.

However, as noted above, "paper barriers" should be included in merger review and their temporary removal could assist to relieve a merger's transitional problems. Furthermore, removal of paper barriers could be a form of negotiated compensation for small carriers if operational difficulties arise during merger integration.

C. Competitive and Non-Discriminatory Pricing

The ASLRRA claims that the Class I railroads price-discriminate between customers on small railroads and those located on the Class I's lines, giving Class I customers favorable prices. Id. at 7. This practice, they state, is especially prevalent for western grain movements originating on short lines. Although the ASLRRA agrees that favorable rates for moving grain are proper when reflecting efficiencies in train loading and movement, it nonetheless claims that a small carrier that can assemble unit trains from multiple loading points is denied the same discounts that the Class I customers receive for unit train loadings. ASLRRA requests that the STB condition any merger or acquisition by requiring that rates and pricing for small railroads be competitive and non-discriminatory.

As the ASLRRA noted, its claims focus principally on rates for grain movements in the West. For increased efficiency, the Class I carriers have encouraged large elevators on their systems to adopt 110-car loading facilities which can load rail cars for a very fast turnaround. This improves asset utilization of the railroad, allowing the carrier to provide a better rate to the large shipper. Small carriers, however, have been unable to meet these efficiencies, and as a result, do not have access to the better rate.

The Department believes that the concern advanced by the ASLRRA has more to do with disputes over pre-existing rates than it does with the rules to be utilized in judging railroad mergers. Unless a link can be made between such rate problems and a merger, we can see no reason for pursuing such issues in this proceeding.

D. Non-Discriminatory Car Supply

The ASLRRA requests that the STB condition mergers so Class I carriers cannot discriminate against small carriers with regard to car supply, especially during car shortage periods. The ASLRRA also believes that small carrier should be compensated by the Class I railroad when car needs are not met. Id. at 8.

Allegations of car discrimination are nothing new when demand for cars exceeds supply. Generally, this would not be perceived as a merger-related issue, and we believe that the ASLRRA has not presented it as one. However, the transition phase in the UP/SP consolidation and in the CSX/NS acquisition of Conrail saw severe car fleet placement and utilization problems resulting in serious car supply issues. The Department believes that the ASLRRA concerns over car discrimination should be narrowed to the context of merger implementation. As a consequence, car supply issues could be accommodated in the development of service benchmarks and negotiated service guarantees between Class I railroads and small carriers.

E. Coordinated Merger Implementation

The ASLRRA asserts that Class I merger transitions could go smoother if connecting Class II and Class III carriers were included in the merger operations implementation and integration process. Id. at 5. In fact, small carriers have performed as "escape valves," relieving service difficulties in the recent Class I mergers. Class II and Class III railroads provided extra capacity through rerouting trains and performed extra switching and blocking for their Class I partners, helping a bad situation from becoming worse.

ASLRRA does not request a specific merger condition to address this issue; however, the Department believes that including Class II and Class III carriers' input in merging Class I service integration planning could be beneficial to ensuring smooth operations and merger implementation.

IX. MERGER-RELATED LABOR ISSUES

The Department has several recommendations to the Board for revising its merger rules as they apply to employees. The Department urges the Board to make the following specific changes: (1) administratively eliminate the widespread use of its "cram down" authority, (2) routinely require the pre-merger completion of implementing agreements, (3) create an alternative for employees who may be forced to relocate great distances or lose benefits as the result of a merger-related transfer, and (4) make the test period earnings records, which are used to determine labor protection benefits, readily available to all employees of merged carriers. [9]

In addition to these specific recommendations, the Department urges the Board to judge not only the impact of the merger on employees, but also the impact that the employees will have on the success of the merged carrier. In a company whose only product is service, the commitment, dedication, and ability of its workforce (employees and managers) to function together as a team will ultimately determine the quality of the service provided to the customer.

Major railroads now employ upwards of 50,000 employees each. These employees are dispersed across large geographic regions covering up to one-half the country. Railroad employees typically work independently in train crews, maintenance gangs, and as signal maintainers, and inspectors. In light of the current and projected concentration of the rail industry, it has never been more important for the Board to consider, along with the operating and capital improvement plans of the merged railroads, whether the employees who will be responsible for carrying out these plans support or oppose the merger, and the reasons behind that support or opposition. The fixed facilities, the equipment, and the information technology systems cannot deliver the service promised. It is the employees who will ultimately bear responsibility for delivering the service safely, reliably, and on-time.

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[9] As used in this context the term "cram down" refers to modifications to collective bargaining agreements, the substitution of one collective bargaining agreements for another, or the transfer of employees from a location covered by a collective bargaining agreement to a location where the position is not covered by an agreement, when these labor contract changes are implemented under the authority of § 11321(a) or 11326 or Section 4 of New York Dock. New York Dock Railway – Control – Brooklyn Eastern District Terminal, 350 I.C.C. 60 (1979).

A. <u>The Use of "Cram Down" Authority</u>

A primary concern of rail labor organizations over the last decade has been the use by the STB and the Interstate Commerce Commission of statutory power to override and modify the pre-merger collective bargaining agreements. 49 U.S.C. § 11321.[10] The labor organizations have long maintained that the immunity provision was never intended to abrogate private labor contracts, and that the carriers should not have been able to utilize the immunity provision to "cram down" collective bargaining changes that they had not been able to obtain through negotiation under the Railway Labor Act.

The Administration has submitted legislation to Congress that would ensure that collective bargaining agreements could only be changed through the procedures of the Railway Labor Act. This legislation would end the anomalous exemption that permits merged carriers to acquire immunity from the the processes of the Railway Labor Act, and it would place all rail industry collective bargaining under uniform and consistent rules under the auspices of the National Mediation Board.

Notwithstanding any legislative change, the use of the Board's cram down authority is an issue that can and should be addressed and remedied forthrightly in this proceeding, before any more railroad mergers come before the Board. The application of the cram down authority is well within the Board's purview in this proceeding, and the Board clearly should revisit the threshold circumstances that warrant the use of this authority.

The Department believes that whatever rationale may have existed twenty years ago to stretch the Board's immunity in merger transactions to permit merged carriers to circumvent Railway Labor Act procedures, that rationale no longer exists today. In an industry with only two major railroads in the East and two in the West, situations of overlapping groups of employees performing the

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[10]Section 11321 exempts railroad merger transactions from "antitrust law and all other law...as necessary...to carry out the transaction." This immunity provision includes the Railway Labor Act. In practice, the STB does not directly modify the collective bargaining agreements. A carrier serves notice on the labor organization of the changes that it is seeking. If negotiations over the proposed change reach an impasse, then either party may invoke binding arbitration. The arbitrator may modify or override the collective bargaining agreement to accommodate the proposed operational changes. The arbitrators are acting as agents of the STB and must conform their awards to STB policies. The losing party to the arbitration may appeal to the STB for review.

same function were eliminated long ago. Redundant assets such as excess track, terminals, maintenance facilities and general offices have been rationalized, and the employees needed to staff excess facilities have left the industry. Employment on Class I railroads declined from 458,000 in 1980 to 178,000 in 1998.[11] In recent years the industry's problems have had more to do with the need to expand capacity than with the need to eliminate it.

Several recent developments and announcements from the railroad industry give further support to the proposition that the time has come to end cram down. For example, the United transportation Union ("UTU") and the major railroads recently announced that they had reached an agreement to end cram down. The Canadian National and Burlington Northern and Santa Fe railroads have indicated that their proposed combination would be implemented without the use of cram down authority. In addition, the Department understands that other unions have been negotiating with the carriers for an agreement to end the use of cram down authority in this respect. The inference from these developments is that the carriers recognize that cram down is not a necessary requirement for a railroad merger.

Under the Board's current application of cram down, a merged carrier seeking an efficiency gain has the ability to use the Board's mandatory arbitration procedures under Section 4 of New York Dock,[12] if the proposal involves employees from two formerly separate railroads. A similarly situated carrier seeking the same type of efficiency gain would have to negotiate under the Railway Labor Act, and arbitration would only be available as an option if both parties agreed to the arbitration.

In addition, the merged carrier has the further advantage that the New York Dock arbitrators are acting as agents of the Board and they must reflect Board policies in their award. If the Board's policy is to realize all the efficiencies that can be obtained from the merger, then it is clear that the carrier has a substantial advantage over the employee representatives in the negotiation/arbitration procedures which the Board has established administratively.

The Department suggests that the Board refine the concept of "necessary" changes to collective bargaining agreements to limited situations that would not

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[11] Railroad Facts, 1999 Edition, at 55.

[12] By the term mandatory arbitration, DOT means that binding arbitration may be invoked by the party seeking change and the other party has no alternative but to accept the binding arbitration.

arise except for the immediate merger transaction. In other words, the test would not only be whether there is an efficiency gain to be realized, but whether the proposed change is so intrinsically related to the merger that the dispute would not arise outside the context of the immediate consolidation. Under this concept, seniority rosters could be combined and seniority districts could be combined in overlapping territories. Where a case can be made that the merger could not be a merger in reality if pre-merger collective bargaining agreements were perpetuated, the Board should adopt the principles of the UTU agreement whereby the employees select the surviving agreement.

These recommendations, if adopted, would address the more egregious excesses of cram down. The circumstances under which this authority can be used are clearly a legitimate issue for the STB to change. Arbitration would be retained when "necessary," e.g., when the parties cannot agree on how to integrate overlapping seniority districts. And, it would finally give employees some input, albeit limited, over the changes that are being forced upon them, by removing the carrier from the process of selecting a surviving agreement.

Although the Department believes that the Board could simply declare that its cram down authority would no longer be used in the labor context, we recognize that the Board may differ with us on this point. Assuming that the Board is not prepared to issue such a declaration, the Department recommends that at the very least, the Board must raise the threshold for when cram down can be used both by changing its definition of when it is necessary to make changes to the collective bargaining agreements, and further by limiting the scope of the circumstances when cram down could be invoked to the initial consolidation, as opposed to changes made at a later date to increase efficiency across the merged system.

B. Relocation Rules and Test Period Earnings

New York Dock benefit standards have not been changed for twenty-five years. The possibility of imminent transcontinental mergers raises the likelihood of transcontinental or other long distance employee relocations. Large scale mergers can put employees in the position of having to "follow their work" to distant locations or lose protective benefits. Under the existing provisions of New York Dock, employees who lose their jobs are entitled to six years income protection. By contrast, employees whose positions are moved to distant locations must either "follow their work" or forfeit New York Dock benefits. Whatever logic this distinction had in the context of the regional mergers that occurred many years ago is lost in the context of continent-spanning mergers. The Department's recommendation, therefore, is to provide employees who must relocate or lose income protection benefits the option of electing a separation allowance or some other benefit alternative that avoids this Hobson's choice.

The Department also believes that employees should have access to their test period earnings.[13] The Department recognizes that there are some practical problems associated with giving employees an unlimited right to their test period earnings. We recognize that the calculation changes from month to month, and the monthly average is only relevant for the twelve month period preceding the month the employee was adversely affected. However, the Department believes that the employee is entitled to request a printed document that shows the calculation of test period earning on a periodic basis. Current technology would seem to make this a minimal burden on the carrier, while providing employees critical information regarding their New York Dock income guarantees.

C. Pre-merger Completion of Implementing Agreements

One of the contributing factors to the service problems experienced on the Union Pacific following its merger with the Southern Pacific may have been the delay in reaching implementing agreements with the operating crafts. As a result shippers' groups recommended completion of implementing agreements as a condition in the Conrail acquisition. Finance Docket No. 33388, Decision No. 89 at 59. Although that transaction has had its own service problems, the Department believes that the early completion of implementing agreements is a reasonable step towards reducing transition-related service problems.

IX. MERGER-RELATED ENVIRONMENTAL/COMMUNITY IMPACT ISSUES

A. Partnerships and Corridor Approaches

The Board administers regulations regarding consideration of environmental impacts from mergers. 49 C.F.R. Part 1105. In general, these regulations address impacts resulting from additional trains, with minimum increases in trains used as the basis for analysis. Grade crossing safety impacts are considered based on rail and highway traffic counts. The reviews also consider increased truck traffic (e.g., at intermodal yards), and the full range of other impacts, the most common of which are noise and air pollution (from

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[13]Under New York Dock, test period earnings are the average monthly earnings for the twelve month period prior to the month that the employee was adversely affected.

traffic delays at crossings and railroad operations). In recent consolidations, the STB has required either an Environmental Impact Statement ("EIS") or and Environmental Assessment ("EA"). As a result of the environmental analysis and subsequent mitigation agreements, many of the more significant impacts in recent cases have been addressed.

Although the ANPRM did not offer changes to existing environmental criteria, the Department believes that the Board should explore ways to address the environmental impacts in areas that, while not meeting the thresholds for mitigation, still suffer in ways that are significant to the community. The STB should also explore options to encourage the railroads to develop solutions with communities and states that focus on traffic "corridors" rather than on individual crossings or similarly delineated areas.

The Department believes this issue is potentially important in future end-to-end mergers. Such transactions would presumably result in international and/or transcontinental rail systems. The advent of such systems would provide incentives for railroads to consider routing traffic away from congested gateways such as Chicago, and increasing the number of trains in certain corridors above the STB's current thresholds. Shifts in train routings and the continued growth in intermodal traffic may result in major increases in truck traffic to and from certain intermodal terminals.

In the Conrail transaction, the STB did not order mitigation for a number of rural or small communities with large increases in train traffic. Grade crossing improvements were not justified due to light highway traffic, and noise mitigation was not justified due to the small number of residences near the railroad. While these impacts in total may be small by some measures, they may be severe impacts indeed for the individuals in those communities. An approach to address these problems needs to be considered.

A new environmental approach must allow for the fact that the railroads and the affected communities need to reach agreement in order to implement most mitigation measures. Because a railroad has no authority to build overpasses, improve crossing protection or install sound walls (often-requested mitigation measures) on its own, community cooperation is essential in what to date has often been an adversarial proceeding.

The high cost of complete mitigation compared to the magnitude of the environmental impact also presents serious equity problems. For example, additional trains inevitably increase highway traffic delay and train noise impacts, yet completely avoiding vehicular delays would require grade separation, often at a cost of millions of dollars. Overpasses, while the best solution in this respect, are usually not very "cost-effective," since they are quite expensive and the increased risks and delays they address are relatively minor. In densely developed areas, it may be difficult to even implement grade separation without negative impacts on the community. Effectively eliminating noise increases could require expensive and visually intrusive sound barriers. The Department encourages the STB to consider new approaches that may be more effective to reduce environmental problems and may also work to cooperatively resolve existing problems.

For "typical" impacts, such as delay and safety risk at crossings or noise impacts from additional trains, railroads and communities should be encouraged to provide improvements on a partnership basis, where the appropriate improvement is jointly funded by the railroad and the community. Currently, communities that have more "clout," and/or that understand the system, pursue significant remedies, often with success, while other communities with less political clout or savvy suffer significant environmental deterioration

The Department recommends that the STB consider establishing a "partnership" approach to mitigating environmental impacts that do not rise to the level of mitigation mandated in an EIS. This approach could be applied to areas that do not qualify for "traditional" mitigation or those improvements that are beyond those otherwise ordered by the Board. Both communities (including state DOT's) and the railroads would contribute to the projects developed under such a partnership, with contributions reflecting the benefits the parties would receive. Railroads would be expected to contribute at least the cost of the minimum level of mitigation ordered by the STB. Railroad contributions over and above that level would reflect the benefits from closing grade crossings and other factors they deem important. Communities would contribute based on benefits derived from eliminating existing problems -- grade crossing delays and hazards and noise from whistles, for example.

By providing an option for funding projects beyond those mandated, railroads and communities could identify and build the best solution, and not be limited to the solution ordered in the FIS. This approach could encourage a corridor approach to solving problems, wherein several communities and the state would agree to a program that, for example, could include upgrading some crossings, closing others and perhaps include a grade separation that would allow a whistle ban. An objective of this program would be to allow every community the opportunity to secure some assistance in mitigating problems, not just those that are severe enough to require the railroad to fund the entire improvement. This approach would allow, for example, expanded opportunities for ports to work with railroads to mitigate congestion problems. The STB should consider how to address the concerns of poorer and smaller communities that might have problems providing the local contribution. It may be desirable to offer some type of matching arrangement between the railroads and the communities to allow these more desirable fixes to take place, but communities should not be given an invitation to take advantage of the happenstance of a merger to address utterly unrelated concerns.

B. New Infrastructure Projects

The STB also should consider requiring the application and the attendant environmental review to cover railroad infrastructure projects needed to meet rail traffic growth projections and to provide quality service. The objective would be a coordination between the measures needed to ensure maintenance of quality service, projections of traffic growth, and the actual planning and approval of the physical infrastructure needed to meet those claims. Railroads should be asked to identify not only construction projects needed to implement the merger (they do this already), but also those needed to provide sufficient capacity to meet the forecast growth in traffic. This approach would help ensure that the merger decision is made based on the infrastructure that is really required to implement it. If the process also covered any prerequisite environmental review, railroads could build needed facilities in a timely manner. Specifically identifying those facilities needed for growth or traffic shifts would also promote a more realistic assessment of potential claims of public benefits from traffic diversion, encourage a more realistic quantification of merger benefits, and dovetail with any transition service plan requirements.

In developing such an approach, the Board should consider that communities may object to having the STB require an EIS for specific local projects and that railroads may be unrealistic in their planning, since it may be difficult to argue that existing facilities are inadequate for growth. This approach may raise the cost of required mitigation significantly and the reviews may take longer than merger approval.

C. Community Congestion

The Department has heard repeated complaints following several recent mergers concerning parked trains blocking grade crossings, causing traffic delays and potentially interfering with emergency response vehicles. This situation makes it more likely that impatient or very young pedestrians will crawl between or under rail cars, placing themselves at great hazard. This is unacceptable to communities. It is also contrary to the ideals of the Administration's Livable Communities initiative, which seeks to improve the quality of life and to ensure healthy, safe, and environmentally sustainable neighborhoods.

The STB should consider requiring railroads to identify plans to avoid blocking grade crossings with parked trains. This could include identifying additional sidings required, crew change points and other actions or construction needed, and could be part of both the long-term implementation plan, and the contingency plan we recommend, as discussed above. This would further encourage railroads to work with communities to close crossings that are inconsistent with smooth operations. However, it may be difficult to identify problem areas before the merger, so there may be a need to require additional remedies after the merger has been implemented. The STB may wish to address the concerns of communities that object to closing grade crossings that conflict with proposed sidings or to allowing trains to be parked on particular sidings.

The issues outlined above may make it worthwhile to consider establishing a more formal process to develop environmental mitigation measures. The process would bring railroads and communities together in a more open process to select, finance and construct mitigation measures. This might help ensure that agreements addressed environmental issues and may allow smaller communities more of an opportunity to participate, although it may make agreements more difficult to reach.

XI. MERGER-RELATED INTERNATIONAL ISSUES

With a single exception, all consolidations of major railroads since the Staggers Rail Act of 1980 have involved U.S.-based carriers. These transactions have presented issues that, over time, have become familiar to participants in ICC/STB proceedings. The effects of each transaction on competition, essential services, communities, rail labor, and safety have been assessed time and again.

Less than one year ago, however, for the first time a substantial combination was approved in which a foreign-based railroad, the Canadian National, acquired a U.S. carrier, the Illinois Central. Finance Docket 33556, Decision No. 37 (served May 25, 1999).[14] That proceeding suggested that there may be issues or implications arising from transactions creating transborder rail systems that are different from those resulting in systems virtually wholly within the U.S. The announcement of the proposed combination of the Burlington

[14]/ We are aware that for years a few smaller railroads in the northern U.S., like the Soo Line and the Grand Trunk Western, have been owned by Canadian rail carriers. A small carrier in the Southwest, the Texas-Mexican Railway, is owned by a Mexican transportation company. But the size of these carriers is dwarfed by the systems now in prospect, and this difference in size may well portend differences in impact on the areas discussed herein.

Northern and Canadian National railroads and the prospect of additional, similar consolidations make it imperative that the Board explore in such cases the existence and extent of any meaningful differences.

The Department is uncertain whether these kinds of transactions necessarily or actually introduce qualitatively different issues. But that uncertainty, particularly when combined with the greater risks attendant to consolidations of the size and geographic scope now contemplated, demands a searching inquiry into the areas most likely to present differences. In that way a record can be established that offers fact rather than conjecture, and tested argument rather than bald assertion. This would provide a basis for the Board to make determinations about the advisability of conditions or even approval itself for mergers that have international aspects. We offer the following concerns, which we believe among those that warrant special attention in major international rail combinations.

A. Safety

The first of these concerns is safety. As noted above, safety integration plans ("SIPs") have become a staple of major rail merger cases to ensure that adequate attention is paid to the safety ramifications of combining large railroads. In the CN/IC proceeding, FRA worked with CN to include in the SIP the necessary information and planning to address the safety effects of the merger in the U.S. Yet the preliminary effort by BN and CN to exclude from the record in Finance Docket 33842 information that they considered germane only to Canada suggests at least the possibility that such cooperation might not always be forthcoming. BN/CN-9. The Board should clearly declare that total cooperation with FRA continues to be a necessity without regard to the national origins of merger applicants, and that what is under consideration are all the impacts of a transaction on the U.S., and not just its U.S. segments.

Another safety issue that is more likely to arise in international transactions also arose in the CN/IC proceeding: the extent of compliance with U.S. safety rules, and the consequent ability of FRA to enforce those standards, with respect to train dispatchers based in a foreign country who dispatch trains operating in the U.S.[15] The matter was not truly resolved in the CN/IC case.

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[15]/ For example, FRA requires random drug and alcohol testing, which Canadian law does not permit that government to impose, and FRA more strictly limits the hours dispatchers can work. Moreover, the Canadian Pacific, owner of the D&H railroad, has apparently already decided to move the dispatching of D&H trains operating in the U.S. to Canada.

There, the CN only agreed to inform FRA in advance of any decision to transfer dispatching of trains operating in the U.S. to Canada. FRA is now working on a rulemaking to address this subject definitively.

B. National Favoritism

A second issue peculiar to international rail consolidations also appeared in the CN/IC case: concerns that important commercial decisions involving the merged railroads could conceivably be based upon national, rather than economic, considerations. We have identified several forms of this concern to date. The first is an adverse action by a foreign-based acquiring or surviving carrier. For example, there might be an effort to influence routing of rail traffic to and from ports in another country at the expense of ports in the U.S. A variation on this theme arose in the CN/IC case. There the State of North Dakota feared that CN would favor Canadian agricultural producers over those in the U.S., and sought conditions to address this issue. The STB held the CN to its representation that it would keep open the rail gateway of concern to North Dakota. Finance Docket No. 33556, Decision No. 37, *supra*, at 37.

Another identified concern is with the indirect effect of foreign government law and regulations on U.S. interests. An example relates to the Canadian Wheat Board, a government entity that controls a large supply of rail cars that it uses for the benefit of Canadian agricultural producers. The role of this institution and its effects on grain movement, agricultural shippers, and railroads – particularly in times of car shortages or grain market fluctuations – have certainly not been explored in any rail merger case since the Staggers Act.[16]

DOT's fundamental view is that reducing the uncertainties, and thus the risks, of transcontinental, international rail systems demands a more exacting examination of the consequences of such transactions. It is important for the Board to recognize that this and other areas are at least appropriate subjects of inquiry. The record produced thereon will provide a suitable basis to address such concerns.

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[16]/ We also understand that the recent post-merger service breakdowns in the U.S. have affected rail shipments and cars to and from Canada, and even intra-Canadian traffic. It is therefore possible that during such period, and perhaps others, international carriers will be subject to pressure from competing groups of shippers in different countries.

C. Corporate Control

Preliminary inquiry has also indicated to the Department that Canadian, Mexican, or other foreign law may present issues in the additional area of corporate structure and management. We understand that a majority of the boards of directors of both CN and CP by law must be Canadian citizens or permanent residents. [17] BN and CN have also agreed that the new holding company of their combined system, North American Railways, will adhere to this requirement, even though that company will be incorporated in Delaware. Finance Docket No. 33842, Decision No. 1A at 2-3 (served December 28, 1999). [18] Legal provisions that tie corporate control to nationality or citizenship also raise the question of reciprocity.

Mexico has proceeded differently in this area: it has separated the ownership of underlying track and rail facilities from the right to operate over them. The Mexican government continues to exercise sole control of the track and rail facilities in that country, and has sold the right to operate on portions of that infrastructure to independent entities. Those entities, however, must remain under the control (51%) of Mexican nationals. Major U.S. railroads have purchased minority stakes in these operating concessions.

Applicants in transborder rail merger proceedings may contend that the applicable laws of all relevant nations will continue to apply to transnational railroads just as they did beforehand. They may also point out that corporate directors owe a fiduciary duty to shareholders, who would not be subject to citizenship/residency or similar requirements. Finally, we have already noted that Canadian carriers own smaller railroads in the U.S. and that U.S. carriers also operate directly and indirectly in Canada and Mexico.

Regardless of this, DOT's point is that future consolidations may well involve international issues which must be considered. The proper way to do this is to create a record on the ramifications of relevant foreign law, such as the Canadian and Mexican examples noted above.

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[17]/ Canadian law also seems to require that CN corporate headquarters be in Montreal and that no individual or entity may own 15% or more of CN; these strictures do not appear to apply to CP.

[18]/ A variation on this theme may be the use of contract terms that required disputes with U.S. parties to be resolved according to the laws of foreign countries. Such provisions may be problematic in the absence of arms-length transactions involving parties of roughly equivalent bargaining positions. DOT is interested in learning more about the extent and circumstances of such provisions.

D. National Defense

There may also be national defense interests that are implicated in the combination of major U.S. railroads and foreign rail carriers. The Department of Defense ("DOD") can certainly be expected to address its own concerns in this area. DOT works closely with DOD and we can thus truly appreciate that national emergencies often require prompt responses from the U.S. rail industry (such as during Desert Shield/Storm). Coordination between DOD and FRA has identified large portions of the nation's rail infrastructure as the strategic rail network, or "STRACNET," which is vital to ensure rail service important to the national defense reaches to and from military facilities and major ports and other points. The Maritime Administration assists to prepare ports and the U.S. ready reserve fleet for the movement of vital materiel. Foreign ownership or control of much of that rail infrastructure and routing decisions that may have an impact on the capability of ports therefore suggest at least the potential for defense concerns. In this area we strongly urge the Board to be attentive to issues raised by DOD, and to mandate the most searching inquiry.

The Department does not consider the above areas exhaustive of the subjects of potential concern in international rail merger proceedings. We offer them as a starting point and we anticipate that other parties may forward additional issues worthy of the STB's consideration.

XII. MERGER-RELATED PUBLIC BENEFIT ISSUES

The Department believes the STB should consider requiring the merging carriers to more rigorously identify the public benefits they believe will result from their merger. These benefits could include benefits to shippers, such as lower rates, single-line service or better routes, or benefits to communities from reduced truck or train traffic. Additional areas of public benefit that might be considered include safety benefits and additional access for passenger trains.

Merging railroads have cited purported service benefits in previous mergers, but no rigorous attempt to identify the magnitude of these benefits has been provided. In the Conrail acquisition, carriers noted that the acquisition offered the opportunity to divert substantial numbers of trucks to rail, reducing congestion, air pollution and highway maintenance costs. However, no estimate of the value of these savings was provided nor were the steps to achieve them set out. Railroads have been required to mitigate negative environmental impacts from mergers, such as those resulting from additional trains over certain routes, but they have not been given credit for the benefits accruing to areas where train traffic has been reduced.

Larger mergers pose greater risks, and therefore the public benefits from such mergers should be more clearly specified. The carriers should provide well-supported estimates of the benefits, the steps they propose to achieve them and some guidance as to when these benefits would accrue to the public. This may encourage the merging carriers to more carefully consider such benefits and take measures to increase them. As mentioned previously, this could include making greater use of the corridor approach to addressing crossing issues. The Board should consider providing guidance on how to better define and quantify such benefits. Better estimates should allow the Board to better judge if those benefits warrant the risks from larger mergers. Since mergers are approved partially on the basis of the public benefits identified, merger oversight should include an assessment of whether the benefits identified have been achieved and, if not, whether the railroad has made the promised efforts necessary to implement them. Railroads should be held to their representations on public benefits, the same as their other representations.

XIV. LOOKING TO THE FUTURE

Finally, on a broader matter, DOT supports the STB's decision to abandon its traditional "one case at a time" approach to rail mergers. The Board must be able to assess the implications of any "downstream" effects of potential mergers, and weigh those impacts against the benefits of the consolidation at hand. We recognize that it will be difficult to put this approach into practice, since it does not lend itself to verifiable evidence, quantification, and expert testimony. Initially, we offer the following suggestions.

We support the proposal in the ANPRM that applicants, as well as other parties, provide assessments of the likely impacts of a proposed combination on the remaining major and regional railroads, and their potential "strategic" responses. Particular attention should be paid to the impact on "orphan" railroads, left without suitable partners, and the effect such a state would have on the shippers that they serve.

The Department also believes that mergers that are proposed within a reasonable time period of each other should be combined and assessed together. Applicants could also be encouraged to offer an analysis of why their particular combination offers benefits that would not be generated by a merger of either with a different partner, or poses fewer risks than another combination.

The Board should also not be reluctant to revisit conditions imposed in a prior merger decision, if a subsequent consolidation renders them ineffective. It may wish to impose an indefinite oversight period on approved combinations, to make it easier to gather evidence in this area.

DOT is still evaluating possible options for realistic evaluations of downstream effects, and we look forward to reviewing the submissions of other parties on this important issue. We caution, however, that crystal ball gazing is not an exact science. Moreover, the Board should not let the quest for the "perfect" rail industry structure prevent approval of combinations that provide good, competitive and innovative service at reasonable rates. It is ultimately the marketplace, not the STB, that should shape the structure of the rail industry.

XV. Conclusion

The Department believes that the issues facing the Board in this proceeding are of paramount importance. As Secretary Slater noted during his testimony in March, the importance of the rail industry and rail infrastructure is not new, but the nature of the industry is very different today than it was even twenty years ago. The Department believes that the high degree of concentration in the Class I rail sector, and the possibility that this may soon increase, compel the Board to rethink the criteria by which rail consolidations are judged. We fully expect that the views filed with the Board in this proceeding will provide a solid basis for the adoption of new standards that take into account both the present composition of the railroad system in this continent and how that network will be comprised in the future.

Respectfully submitted,

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NANCY E. MCFADDEN
General Counsel

May 16, 2000

CERTIFICATE OF SERVICE

I hereby certify that I have on this day caused to be served on all Parties of Record by first-class mail, postage prepaid, a copy of the foregoing Initial Comments of the United States Department of Transportation filed in Ex Parte No. 582 (Sub-No. 1).

Paul Samuel Smith

Paul Samuel Smith

May 16, 2000